



The European Trade Association for Business Angels,
Seed Funds, and other Early Stage Market Players

eban White Paper *October 2010*

Early stage investing:

An asset class in support of the
EU strategy for growth and jobs.

*A recipe for the EU to become one of the
world's most dynamic early-stage
investment markets.*

Executive Summary

The European early-stage investment market has changed significantly over the last 10 years. When EBAN was created as the European Business Angel Network in 1999, only 50 angel networks operated in Europe, half of which were located in the United Kingdom. As EBAN closes its 2010 annual research on the market, over 350 organised networks and groups have been identified – and we know these to be only the tip of the iceberg. These groups gather some 20,000 angels and receive 40,000 business plans on average every year. Moreover, there is now a clear interest from business angels, traditionally local investors, to look at collaboration (including investment) opportunities in different countries throughout Europe and beyond.

On the early-stage seed capital fund side, the environment has also evolved tremendously, with a growing number of regional funds supported by the public sector, in order to fill the equity gap, as well as a growing number of angel funds and serial entrepreneur funds emerging in the last five years. These funds, be they recipients of public funds, fully private or more frequently a mixture of both, are growing themselves into an autonomous asset class, away from bigger and more traditional venture capital funds that are focused on later-stage deals and do have quite a different approach to investing. Seed funds require skills that are clearly based on the capability of their management to evaluate and support entrepreneurial teams rather than financials and technology. Although there does not yet exist full research on the number, size and long-term viability of these early-stage funds, a preliminary investigation by EBAN indicates that there are a few hundred in Europe with an average size of around 10 million€ each.

This growing marketplace has been stimulated by an increased awareness, Europe-wide, of the activity of early-stage investors and their contribution to the financing of high-growth innovative companies. With the recent economic and financial crisis, this realisation has increased as both traditional sources of funding (debt funding through the banks) and traditional venture capital funds have either slowed down financing early-stage SMEs or have focused on their current portfolio. In particular, business angels and early-stage funds have been recognised as a vital source not only of seed capital but also of experience and knowledge available to innovative companies.

Nevertheless, this growing early-stage investment asset class faces a number of challenges that need to be addressed at the structural level with the support of European policy makers in the European Parliament, the European Commission and other bodies, with the support of EBAN as the trade association for early-stage investors, and at the micro-level by the networks and the funds themselves.

EBAN identifies in 2010 a series of major challenges that will affect our market in the coming years:

- Lack of fiscal incentives to encourage early-stage investments
- Follow-on rounds for existing early-stage investments, international expansion of invested deals and preparation for exits
- Financial sustainability of business angel networks and seed funds with the reduction or withdrawal of public financing
- Professionalisation of the market to enable co-investments between public/private entities and cross-border syndication – and capacity building of policy makers
- Lack of harmonisation of fiscal environments and systems encouraging early-stage activity
- Structural obstacles in cross-border collaboration
- Tendency toward heavy-touch regulation for the early-stage investment market.

As a result, EBAN will focus its efforts over the next three years on the following priorities for the marketplace:

- * Professional standards and accreditation
- * Collection and conversion of data into useful information for key players of the ecosystem
- * Lobbying
- * Awareness and Capacity Building
- * Cross-border syndication and co-investment support.

The purpose of the EBAN White Paper is to present an updated perspective to policy makers regarding the key issues at stake for business angels and early-stage venture funds in the next few years, and propose some solutions to respond to the challenges listed above.

The White Paper is an invitation to all concerned actors to take action in favour of the proposed initiatives.

Introduction

Since the publication of EBAN's White Paper in 2007 in the framework of the Portuguese Presidency of the EU, the equity gap for early-growth-sustainable businesses has persisted and widened, particularly as a result of the recent downturn. It is now a widely accepted fact that business angels and early-stage funds help to bridge this equity gap and that their activity needs to be stimulated further by the public sector, without, however, distorting or crowding out the market. It is essential for EU policy makers to use EBAN as a key partner and sounding-board for the implementation of new instruments or the improvement of current schemes.

The evolution of EBAN as a trade association itself illustrates the changes that have occurred on the market over the last few years. Throughout this publication, when referring to early-stage investors, EBAN includes the following actors: business angels and early-stage venture capital funds investing less than 3m€ per deal, and other early-stage investors.

As a result of an evolving market environment, EBAN as a trade association has opened its focus (in 2009) to include all venture capital actors investing in the sub 3m€ equity gap. It has followed trends witnessed in some of the most mature angel markets, such as the UK, the Benelux or France, where business angels and early-stage venture funds were increasingly drawn to one another as co-investors as a result of the migration of traditional VC funds from early-stage activity towards larger and later-stage deals.

Business angels, working together in syndicates, invest on average 200,000€ per deal in Europe (often with two or more angels involved). The amount invested can vary greatly depending on the country and region, with individual angel investments ranging from 15,000€ to 400,000€. On the other hand, seed funds are bridging promising businesses to later stages, investing in enterprises on average 700,000€, ranging from 200,000€ to 1m€, also in conjunction with business angels and informal investors.

At the same time – and this phenomenon has been amplified with the current financial and economic crisis – venture capital funds have become more preoccupied with their current portfolios due to a fixed fund capacity and have retreated to even later stages of investment, typically investing from 3m€ to 5m€ in a first round to reduce the risk for their shareholders.

A diminishing number of venture capital actors are willing to take risks on early-stage innovative companies due to these structural difficulties and due to the different skills needed to correctly evaluate the potential in very early stage business propositions.

For policy makers to close this equity gap successfully, a specific strategy, dedicated to the early stage, is needed, but focusing on the very early stage: i.e. supporting angel and early-stage VC-backed companies in their growth and internationalisation strategies.

In the coming years, EBAN sees the following trends in the market:

- * At the systemic level, an evolution from market growth to market sophistication with a greater need for professionalisation and capacity building for all actors involved in the market
- * At the network level, a slight increase in the overall number of networks in younger markets such as Eastern and Southern Europe, balanced by a rationalisation in other countries and a diminishing number of bigger groups
- * An increasing number of private investors stimulated by fiscal incentives in different Member States, and therefore a slightly increasing number of business angels from this group (actively supporting entrepreneurs, not only with their capital)
- * An increasing number of regional early stage-funds activated by European Regional Development Fund policies and by private investors' own initiatives that are starting to produce interesting results in the market, even if they are still facing difficulties in finding the necessary resources to operate.
- * The evolution of the market is creating a new set of needs that will be addressed by EBAN at the pan-European level in the coming years by focusing on:
 - * Professional standards and codes of conduct for the market
 - * Benchmarking through research and organisation of events
 - * Lobbying to ensure a favourable working environment for angels and seed funds
 - * Awareness-raising and capacity-building
 - * Support to cross-border collaboration and syndication.

EBAN calls on the European Commission and the European Parliament to carefully review the recommendations of this White Paper to reduce the equity gap and make sure that great European companies continue to raise funding and have access to mentoring to grow global businesses.

¹ EBAN Statistics Compendium 2009

² Based on the recent "Statement on the impact of the financial crisis for angels", published in 2009, and the "Contribution of early stage investors to the EU2020 Strategy", published in 2010, both available on www.eban.org

1. Adapting to a fast-changing environment and providing flexible and timely support to the market

EVOLVING WITH THE FINANCIAL MARKET – CAPACITY-BUILDING OF POLICY MAKERS

Policy makers need to ensure that the existing financial instruments that are targeted at early-stage investors are being implemented properly. One needs to take into account that the main issue with the current lack of drawdown of finance by early-stage investors from instruments such as GIF 1 (High Growth and Innovative SME Facility), which EBAN had strongly advocated, lies in the execution.

There needs to be sufficient staff with experience in early-stage investment within the different agencies that deal with financial instruments that are in charge of funding early-stage projects (including at the European Investment Fund level).

Policy makers must understand that business angel networks and groups and seed funds cannot be evaluated with the same lens and criteria as venture capital funds. Business angels have an increasing mentoring role to play when funding high-growth companies; however, they have a different approach from professional investors (i.e. fund managers).

Public authorities need to become educated about the new reality of access to finance for early-stage high-growth companies, to become efficient at implementing existing instruments specially designed to stimulate the early-stage investment market. Some 10 years ago, business angels were a small community scattered across Europe, and venture capital funds were the panacea. Today, business angels are organised in groups (over 350 across Europe), and it is widely accepted that, together with seed funds, they are the main providers of venture capital for the high-growth companies at their early stages as VC funds have migrated to less risky investments in later stages. Business angels increasingly co-invest with other angels and with early-stage funds in an effort to fill the early-stage equity gap in Europe.

MAKING A DIFFERENCE – CRITICAL MASS AND ADDRESSING SMALLER-END MARKETS

There are two main issues with the financial market in Europe today. The first is that the market is fragmented, and that there are too many small funds operating with no critical mass to grow world-class companies. This is particularly true in the biotechnology sector, where promising companies have to go to the US to raise significant amount of capital to grow their business. The EU2020 should therefore not only attract institutional investors to support venture capital funds Europe-wide, but also stimulate the **creation of a large cross-border venture capital fund that can co-invest with a number of selected national early-stage players in order to leverage their resources and bridge the equity gap for most promising early-stage initiatives with an international breadth.**

By the same token, if policy places an emphasis on the early stage, then its financial instruments need to be adapted to the reality of the latter. A pan-European co-investment fund can be a very strong mechanism to leverage funding from private investors at the early stage, even if it is a small fund compared to initiatives needed for different sectors or stages. Again, for these types of funds, investing mostly at the seed level, availability of resources is not necessarily the issue. There are two elements lacking:

- to ensure clear objectives and **professional market-driven standards** through the training of regional civil servants and the development of guidelines to ensure that the funds are spent on Young Innovative Companies;
- to implement a legislative framework in the form of a single **European small funds management company**, enabling the smooth operation of such funds so that there can be some different administrative and legal requirements to set up smaller funds addressed to early-stage high-growth companies.

PROMOTING CROSS-BORDER COLLABORATION AND INVESTMENT BY EARLY-STAGE INVESTORS

In 2020, for an efficient and competitive Europe, the European authorities should have achieved:

- * a single European patent;
- * harmonisation of company laws (bankruptcy in particular);
- * harmonisation of the fiscal and legal frameworks affecting investors and companies;
- * a light-touch regulation system within the early-stage investment market.

The European Union should support initiatives that foster cross-border collaboration in the following forms:

- * Internationalisation of SMEs across Europe
- * Cross-border investment by investors.

The EU should also strive to reduce barriers that impede the above with the help of early-stage investors.

WHAT THE EU CAN DO:

- Create co-investment funds through public-private partnerships at European level is essential to develop local financial communities and ecosystems. Moreover, they provide an incentive for investors to remain active in follow-on rounds and continue to make their time and network available to their investee companies. Experience has shown that co-investment funds are an efficient way to leverage private sector participation in the market.
- Encourage Member States to create or increase special fiscal incentives for investments in Young Innovative Companies, thereby stimulating the participation of a higher number of business angels in the market.
- Remove obstacles to cross-border investments by venture capital funds through mutual recognition and a stronger and more transparent regulatory framework to conduct cross-border investments.
- Lighten regulation in the early-stage investment market.

IMPROVING THE LINK BETWEEN DIFFERENT TYPES OF MARKET ACTORS TO FACILITATE THE GROWTH OF COMPANIES AND EXIT OPPORTUNITIES

In order to achieve a measurable increase in the number of deals closed by business angels and early-stage seed funds, it is necessary to improve the connection to other financial actors. This means that business angel investors must find suitable partners to finance the growth of the company and enable them to exit in the medium/long term. However, it is also possible to improve the deal flow for the investors by connecting them with entities that are likely to provide competitive and relevant business projects for the angels.

The efficiency of the marketplace can be enhanced if it relies upon as many different stakeholders as possible, including angels and angel syndicates as well as seed funds, venture capitalists and regional (co-investment) funds around the same objective of growing companies.

In terms of raising awareness, actors in the ecosystem such as banks (including private banks), family offices, wealth managers and institutional investors, all need to become further acquainted with the activity of angels and early-stage funds and how they can benefit from greater relationships with them.

The respective contributions of business angels and venture capitalists occur at different stages of the business lifecycle and have different goals. Business angels make their own investment decisions and invest their own money, while venture capitalists invest on behalf of independent private sources. The motivations behind the investments and the amounts invested

are different. However, it is necessary to improve the collaboration between business angel networks and venture capital firms to ease the fluidity of the market, and ensure that potentially high growth companies do not fail because they are unable to find follow-on funding. Improving communication and understanding between the two actors is essential to avoid power struggles and stereotypes. Each actor must understand the final benefit for the company.

WHAT THE EU CAN DO:

- Organise regular dialogues between all the actors involved in financing SMEs, helping to support networking between those actors
- EBAN would welcome any initiative aiming to organise a programme (which could be organised by EBAN and EVCA with the support of organisations such as the Enterprise Europe Network) to deliver a series of local workshops to build local financial ecosystems and to map investment activity for high growth entrepreneurs at regional level
- The EU should recommend to Member States that they ensure that there are no unreasonable regulations standing in the way of SMEs being able to promote investment opportunities or individual investors, who they reasonably believe are either high-net-worth individuals or sophisticated investors. This includes solving the financial regulations and prospectus directives, which create the following hurdles:

- » Issues for angels who have the opportunity to go to IPO with their company as they cannot call on public savings
- » Administrative burden when individual investors have to publish information about their investments

- In order to reduce regulatory problems, shared operational frameworks and industry standards should be implemented across Europe as long as it is realistic
- Support the creation of an integrated ecosystem that incorporates the actors of the early investment arena.

ADDRESSING THE LINK BETWEEN FINANCING INNOVATION AND PUBLIC PROCUREMENT

EBAN advocates the creation of an efficient mechanism for Member States to buy a significant portion of their products and services from SMEs. There is also a strong link between the procurement of R&D services and the financing of innovation within companies.

ADDRESSING DIVERSITY TO SOLVE SOCIETAL CHALLENGES

It is important to achieve the uniformity of “social enterprise” creation. One of the main issues for lower-paid people or minorities is the complexity of setting up a new company and the minimum of equity that might be required to do so. This varies from country to country. A European Social Enterprise would help bring new entrepreneurs and companies to the market, with simpler administrative and financial procedures and distinct company status.

WHAT THE EU CAN DO:

- Investments in micro- and social enterprises in Europe by private investors should be encouraged.

Entrepreneurs and business angels come from very diverse backgrounds. Further support needs to be provided to women-led businesses that are in a period of transition from a long start-up phase to a ready-for-growth phase. At the moment, there is no support provided on the market for them, and there is a risk that these companies may not reach their full potential.

- By the same token, the European Union should consider supporting the creation of a European-wide community of women angel investors and supporting other programmes designed to encourage women to become angel investors. Women are still under-represented in the business angel market, being under 5% of the total number of investors. Supporting the emergence of a cross-border community would be instrumental in both raising awareness about the potential for women to become investors and ultimately to get more funding for the projects.

2. Addressing supply & demand side-issues

LEVERAGING UNTAPPED INVESTMENT POTENTIAL AND ACTIVATING VIRGIN ANGELS

EBAN estimates that the number of business angels in Europe is around 75,000, a small number in comparison to the US, which has an estimated 250,000. The European angel market represents circa 25% of the American angel market. In order to increase the volume of business angels, and the number of

risky but potentially high-growth businesses accessing finance, there is a need to stimulate the numbers of experienced informal investors in the market.

The need to attract more business angels to the market has been highlighted in recent years by:

- * The crisis and the depletion of traditional sources of finance and therefore an increased demand from SMEs on existing networks
- * The current focus of many existing angel investors to support their existing portfolio companies rather than invest in new deals.

There is therefore an increased need for capacity-building at the level of:

- * Prospective and existing business angels
- * Entrepreneurs
- * Business angel network managers
- * Seed fund managers.

Such programmes can increase the quality of the deal-flow for investors whilst bringing more educated investors to the market. They would also promote professional intermediary organisations that are managed by individuals who have experience as angels or VCs.

The most efficient way of attracting new angels to the market is through:

- * Fiscal incentives upfront, when the equity is invested into the company, and upon exit, when the investor sells its capital share .
- * The establishment of professional business angel networks
- * Awareness campaigns launched to draw attention to the possibilities offered by business angel investing for potential investors and entrepreneurs.
- * An awareness campaign specifically targeted to women angel investors
- * Capacity-building programmes.

WHAT THE EU CAN DO:

- Support **research on the market**: unfortunately, there are too few figures available on the business angel market and detailing particular rates of return for angels. The promotion of success stories and the publication of sensible data will:

- » Improve the visibility of the angel market
- » Raise the profile of angel investors
- » Convince policy makers and prospective angels about the impact of the angel activity in Europe

- Provide **direct support to business angel networks** and **early-stage funds**, especially those who wish to invest outside their region and across Europe in collaboration with angels

- Supporting EBAN's efforts in **establishing** professional standards by supporting the setting up of an accreditation system for business angel networks with a system of compliance, in the same way as the EC has allocated to EBN – European Business Incubation Network the management of the “BIC” label
- Promote EBAN's research on fiscal incentives available to early-stage investors in Europe for policy makers across Europe to understand the relationship between fiscal incentives and increase of the private investor base
- Build potential business angel capacity through the introduction of training programmes delivered by business angel networks and other professional actors
- Support the organisation of **awareness campaigns** throughout the EU, specifically dedicated to the promotion of success stories and the establishment of new networks
- Apply the existing **“capacity-building scheme”** which aims to improve the financial and technical expertise of financial intermediaries investing in SMEs, not only to VC fund managers but also to BAN managers who lack the funding to participate in courses.

IMPROVING THE QUALITY OF DEAL-FLOW AND REDUCING INFORMATION ASYMMETRIES

It is widely accepted that there exists an information asymmetry between entrepreneurs and investors. Investors claim that there is enough money on the market for good projects, which are scarce. On the other hand, entrepreneurs argue that they cannot find investors for their projects.

Entrepreneurs fail to access finance for their company for three main reasons:

- Poor and unrealistic business plan
- Lack of knowledge of the diversity of financial sources and those suitable for their business
- Lack of knowledge on how to successfully approach, and professionally present, business cases to potential investors with a proper understanding of the needs of investors.

The provision of so-called “investment readiness” training can improve the situation by preparing entrepreneurs to strengthen their business plan, understand and meet different types of investors, and understand the strengths and weaknesses of their business, including aspects linked to the management team.

The SMEs management team is indeed the most important factor in the decision-making process of early-stage investors. It is also widely accepted that in Europe, entrepreneurs also suffer from a sales and marketing gap that should be addressed at the early stage of their entrepreneurial career.

WHAT THE EU CAN DO:

- Support investor and investment readiness programmes delivered by business angel networks
- Ensure that entrepreneurship and topics related to investment readiness should be taught in all schools at a very early stage in order to raise the entrepreneurship spirit of the EU students.

SUPPORTING EXISTING ANGELS AND SEED FUNDS

The widening equity gap has led to several challenges for angels and seed funds:

- The necessity for them to have follow-on capacity, where no other investor is present to enter in the second or third round when amounts are still too low and risks too high for most VCs
- The necessity to form structured angel syndicates
- The necessity to find instruments/funds to leverage on their investment capacity.

Solutions to these issues are:

- The development of angel syndicates allowing investors to diversify their portfolios and increase the amount of finance available for a deal
- The development across Europe of public-private partnerships in the form of co-investment funds to leverage on the first investment made by the angel and make more funding available for the growth of the company
- The development of the collaboration between business angel networks and early-stage venture capital firms to increase the potential to find finance for the further rounds immediately.

WHAT THE EU CAN DO:

- Support the creation of Proof of Concept Funds in major Universities and Research Centres managed by private players other than those of the research institutions
- Support the creation of early-stage investment funds or co-investment funds through public-private partnerships
- Use EBAN as a key partner in the evaluation of the professionalism and experience of the networks and the early-stage funds.

³ See EBAN's annual Compendium on fiscal incentives available to private investors across Europe.



EBAN is the European Trade Association for business angels,
seed funds and early stage market players.

Our mission is to support the growth and professionalisation
of the early stage investing sector, from a 3 billion€ to a 10 billion€ asset class,
up from 1 billion€ 5 years ago.

The full and updated list of EBAN members can be found at
www.eban.org/membership/directory

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